Theory Behind Risk Management Article written by James Vanderberg, Luma Group Hong Kong

1888 PressRelease - To assist clients with risk management, client advisors must be aware of their clients risk perceptions.

Malkiel (1982) emphasized the practical importance of risk perceptions and measurement as follows:

The quest for better risk measures is not simply an amusing exercise that accomplishes only the satisfaction of permitting academics to play with their computers. It has important implications for protecting investors.

Early empirical research, using utility-based models, suggested that risk might he measured by return distribution moments such as variance and skewness (Coombes and Bowen 1971. Cooley 1977). Recent studies suggest that the observed correlation between return distribution moments and risk perceptions is spurious and results from decision makers' focus on loss or the possibility of realizing a return below some "target" or "aspiration" Level (Payne 1973; Laughhunn and Payne 1930; Shapira 1995). In addition, empirical evidence suggests that decision makers do not treat probabilities and outcomes in the multiplicative fashion assumed by most generalized utility models (Slovic 1967, Camerer 1994). Cognitive research shows that individuals, with their finite information-gathering and -processing capacities rely heavily on heuristics to reduce the mental strain of decision making.

Thus, individuals are subject to "framing effects," which may tend to focus their attention on idiosyncratic risk dimensions (Kahneman and Tversky 1992, March and Shapira 1992, F Hogarth and Kunreuther 1995).

The purpose of this study is to see if it is possible to identify a common set of risk attributes that have market significance. The study is unique in that it relies upon survey data gathered from influential expert and knowledgeable novice investors in a natural setting.

RISK AS AN EMERGENT PHENOMENON

Risk belongs to a class of phenomena that physical scientists refer to as "emergent." An emergent phenomenon has unique, measurable dimensions that only arise out of the unique complexity of a situation, for example, time is an emergent phenomenon. By itself, time, like all emergent phenomena, has no independent reality. A "time-measurement" dimension can arise, however, that is dependent upon specific circumstances.

For example, if one is concerned with physical aging, time could be measured in chronological years, whereas if weather conditions are important, time might be measured by the passage of the seasons, Lopes (1987) appears to have had this concept in mind when she stated that risk measures must have 'psychological fidelity." That is, risk must be defined and measured in a way that ties a stimulus to a particular behavior. More specifically, risk must be related to the loss of what one values. For example, if avoidance of being plunged into poverty is a primary consideration, risk might he related to the loss of a large amount of wealth.

Alternatively, if the demonstration of superior investment ability is of value, risk might be associated with a portfolio return above that of one's colleagues.

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